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## Section 338 — An Analysis and Proposals for Reform

*R. Lawrence Heinkel\**

### I. Introduction

An expanding corporation can acquire the assets of another corporation in a multitude of ways. The most obvious method is to purchase the assets directly. Alternatively, the acquiring corporation can purchase the shares of the target corporation and liquidate it, obtaining the assets indirectly. Both methods can afford the acquiring corporation and the target's stockholders substantially equal economic benefits and tax treatment.

Prior to the enactment of the Tax Equity and Fiscal Responsibility Act of 1982<sup>1</sup> (TEFRA), the direct purchase method gave the acquiring corporation (P) a fair market value basis in the assets acquired,<sup>2</sup> while the target corporation (T) merely owned cash and installment obligations received on the sale of its assets to P. Unless T's stockholders desired to preserve T as a non-operating corporation, T could be liquidated. This sale and liquidation was generally accomplished in a manner which avoided the necessity of T recognizing gain or loss on the sale of its assets.<sup>3</sup> In the liquidation, the stockhold-

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1 Pub. L. No. 97-248, 1982 U.S. CODE CONG. & AD. NEWS (96 Stat.) 324.

2 I.R.C. § 1012 (1976). Basis of property is generally its cost, adjusted elsewhere in the Code to reflect depreciation and other items. I.R.C. § 1016 (West Supp. 1983). The purpose of basis for an asset is to ensure that on its disposition no gain is recognized until the taxpayer has had a return of his capital or investment in the asset. For example, if an asset is acquired for its fair market value of \$25 on January 1, 1980, and is sold two years later on January 1, 1982, for its then fair market value of \$30, the gain realized is the excess of the amount realized (\$30) over the adjusted basis (\$25 ignoring any adjustments), or \$5. I.R.C. § 1001 (1976 & Supp. V 1981). The taxpayer is not taxed on the entire consideration received; rather, the taxpayer first receives his investment (\$25) tax-free and is taxed only on the excess. *Id.*

3 Generally, T can avoid the recognition of gain or loss on the sale of its assets if such sales are pursuant to a plan of complete liquidation, the sales are made within 12 months of the adoption of such plan and T is completely liquidated within 12 months. I.R.C. § 337 (West Supp. 1983). No gain or loss is recognized by T when it distributes its assets in exchange for its own stock in complete liquidation. I.R.C. § 336 (West Supp. 1983). This is known as a § 337 liquidation.

ers surrendered their shares in T for the cash and installment obligations T owned, and received favorable capital gain treatment on the exchange.<sup>4</sup> Despite the general nonrecognition rule on its sale of assets, however, the target corporation was required to recognize certain "recapture" items.<sup>5</sup> Depending on the nature of the assets sold, the recapture "cost" was sometimes quite high.

If the indirect method was employed, P purchased shares of T from T's stockholders for the fair market value of T's assets. Once P owned T in a parent-subsidiary relationship,<sup>6</sup> P completely liquidated T, surrendering its newly-acquired T stock and receiving all of T's assets in exchange. P did not recognize any gain or loss on the liquidation<sup>7</sup> and, if P purchased the target corporation's shares for the sole purpose of indirectly acquiring its assets, P took T's assets with a fair market value basis.<sup>8</sup> Thus, P acquired T's assets indirectly

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4 Usually when stockholders receive a corporate distribution with respect to their shares, the receipts must run the gauntlet of §§ 302 and 301 to determine if such amounts constitute dividends and are taxable as ordinary income. I.R.C. § 301(c)(1) (1976). If the distribution is received in a complete liquidation, the amounts are treated as full payment in exchange for the stock surrendered and taxed as capital gain or loss. I.R.C. § 331 (West Supp. 1983).

5 A taxpayer can utilize certain provisions of the Code which are designed to compensate him for wear and tear on assets, such as the various depreciation deductions. In certain circumstances, Congress has granted taxpayers substantial tax breaks designed to stimulate the economy and encourage investment in new plant and equipment. Examples of these include accelerated depreciation (I.R.C. §§ 167(b) (1976), 168(b) (West Supp. 1983)) and the investment tax credit (I.R.C. § 46(a)(2) (West Supp. 1983)). Since Congress has generously granted these breaks which offset ordinary income when used, it would be too generous to grant them outright. Therefore, these benefits are only "loaned" to the taxpayer and recalled or "recaptured" when he disposes of the asset. The previously-taken extra depreciation and the unearned investment tax credit are recaptured and brought into the taxpayer's gross income as ordinary income. The circle is then complete. The tax benefits originally offset ordinary income and are recaptured as ordinary income. The tax break is only temporary.

The notion of recapture is so strong that it overrides many otherwise nonrecognition statutes. For example, recapture is required despite the general nonrecognition rule of a § 337 liquidation or § 336 liquidation. I.R.C. §§ 1245(a)(1), (b) (1976 & Supp. V 1981); § 1250(d), (i) (1976); 47(a)(1), (b) (1976). For purposes of this article, "recapture" also includes the assignment of income doctrine, *Commissioner v. Kuckenberg*, 309 F.2d 202 (9th Cir. 1962), and the tax benefit rule, *Estate of David B. Munter*, 63 T.C. 663 (1975). See Bonovitz, *Problems in Achieving Parity in Tax Treatment Under Sections 337 and 334(b)(2)*, 34 INST. ON FED. TAX'N 57, 68-72 (1976).

6 A parent-subsidiary relationship exists when the parent "controls" the subsidiary. Control exists when the parent owns at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of all other classes of stock of the subsidiary. I.R.C. § 368(c) (1976).

7 I.R.C. § 332(a) (1976) permitted P to receive T's assets in exchange for P's stock in T without the recognition of gain or loss. To qualify for the preferential treatment of I.R.C. § 332(a), P had to have "control" continuously from the date of adoption of the plan of liquidation until P actually received the assets.

8 The general rule is that assets received in complete liquidation of a subsidiary under I.R.C. § 332(a) (1976) took the same basis in P's hands as the assets had in T's hands. An

through liquidation but with the same tax treatment accorded a direct purchase. P got the assets with a fair market value basis,<sup>9</sup> T recognized no gain or loss at the corporate level (other than recapture cost),<sup>10</sup> and any gain or loss T's stockholders recognized would be of a capital nature.<sup>11</sup>

The similarity of the tax treatment of direct and indirect asset acquisitions was not coincidental. Courts perceived that a corporation might try to acquire assets of a target by some indirect method.<sup>12</sup> Congress sought to equate, as nearly as possible in terms of gain recognition and asset basis calculation, the tax treatment accorded direct and indirect asset acquisitions,<sup>13</sup> for the legislators believed that tax considerations should not be a factor in the decision of which method to implement.

This article explains how the direct and indirect methods were exploited to achieve results which Congress never intended. Internal Revenue Code section 338, Congress' answer to these abuses, is explored in detail. Problems and gray areas remaining after the enactment of section 338 are highlighted and discussed. Lastly, this article

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exception to this carryover basis was originally provided when the purpose of P's stock acquisition was to indirectly acquire T's assets. In that case, it was felt more equitable to treat the transaction as if the assets were purchased directly so that the assets took a fair market value (although cost) basis rather than carryover basis. *Kimbell-Diamond Milling Co.*, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir. 1951).

After the codification of the *Kimbell-Diamond* doctrine in 1954, I.R.C. § 334(b)(2) provided fair market value basis to assets received in the complete liquidation of a subsidiary if certain tests were met. First, the parent had to acquire the stock of the target by "purchase," defined as any acquisition other than (a) in a manner that P's basis in the stock was determined by reference to the basis such stock had in the hands of the transferee or determined by I.R.C. § 1014(a) (1976 & Supp. V 1981); (b) in an exchange to which I.R.C. § 351 (West Supp. 1983) applied; or (c) in other ways not germane here. I.R.C. § 334(b)(3) (West Supp. 1983). Second, the acquiring corporation had to "purchase" control within a 12-month period beginning, generally, on the date of P's first "purchase" of T stock. I.R.C. § 334(b)(2)(B)(i) (West Supp. 1983). Third, the plan of liquidation had to have been adopted within two years of the date P satisfied the control test. I.R.C. § 334(b)(2)(A) (West Supp. 1983). Fourth, the parent had to complete the liquidation within three years of the adoption of the plan. I.R.C. § 332(b)(3) (1976). This gave P a total of five years from the date control was acquired to liquidate T and still receive fair market value or stepped-up basis.

9 See I.R.C. § 334(b)(2) (West Supp. 1983) for the indirect method, I.R.C. § 1012 (1976) for the direct method.

10 See I.R.C. § 336(a) (West Supp. 1983) for the indirect method, I.R.C. § 337(a) (West Supp. 1983) for the direct method.

11 See I.R.C. § 1001(a) (1976) for the indirect method, I.R.C. § 331(a)(1) (West Supp. 1983) for the direct method.

12 See, e.g., *Kimbell-Diamond Milling Co.*, 14 T.C. 74 (1950).

13 I.R.C. § 334(b)(2) (West Supp. 1983) was enacted to effectuate principles derived from *Kimbell-Diamond*. S. REP. NO. 1622, 83d Cong., 2d Sess. 257 (1954); BITTKER & EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 11.44, 11-42, 45 (3d ed. 1971).

explains how the areas of abuse can be remedied in a more straightforward and comprehensive fashion, avoiding the extensive, complex revisions of section 338.

## II. Abuses of the Direct and Indirect Methods

### A. *Implicit Election*

Over the years, certain practices involved in corporate acquisitions and mergers have frustrated congressional intent underlying the relevant Internal Revenue Code provisions. These devices have resulted in substantial tax savings to the corporate participants, while contributing nothing to economic recovery. The abuses centered around the fact that section 334(b)(2), the statute granting a step-up in the assets' bases to their fair market values,<sup>14</sup> was implicitly an elective provision.

Section 334(b)(2) required at least four steps to ensure its successful application,<sup>15</sup> and failure to meet any one of the tests, whether unintentional or willful, rendered the section inapplicable.<sup>16</sup> If section 334(b)(2) could not be used, section 334(b)(1) was available. This section allowed P to have the assets with the same bases they had in the hands of the acquired corporation (that is, carryover bases). No recapture recognition was required if P took the assets with carryover bases.<sup>17</sup>

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14 See note 13 *supra*.

15 See note 8 *supra*.

16 I.R.C. § 334(b)(2) (1976) was the exclusive manner to receive assets from a target with a stepped-up basis, rather than a safe harbor. *Chrome Plate, Inc. v. United States*, 614 F.2d 990 (5th Cir. 1980); *cf. American Potash and Chemical Corp. v. United States*, 339 F.2d 194 (Ct. Cl. 1968).

Therefore, even if P purchased the stock of T with the intent of acquiring its assets through liquidation, the intent was disregarded and the assets were received with a carryover basis (and no recapture required) if (1) P deliberately waited longer than two years to adopt a plan of liquidation, I.R.C. § 334(b)(2)(A) (1976); (2) T took longer than three years to distribute its assets to P in complete liquidation, I.R.C. § 334(b)(2)(B)(i) (1976); (3) P took longer than 12 months to "purchase" control, I.R.C. § 334(b)(2)(B)(i) (1976); or (4) P transferred its T stock to a wholly-owned subsidiary (S) in a § 351 exchange and S liquidated T, I.R.C. § 334(b)(3) (1976). See also *Chrome Plate*, 614 F.2d 990.

17 If a parent liquidated a subsidiary (I.R.C. § 332(a) (1976)) in a manner inconsistent with the requirements of I.R.C. § 334(b)(2) (1976), the general rule of I.R.C. § 334(b)(1) (1976) controlled. The assets were received with a carryover basis and there would be no depreciation or investment tax credit recapture. In any situation in which basis is carried over in an I.R.C. § 332 (1976) liquidation, depreciation and investment tax credit recapture is deferred. I.R.C. §§ 47(b)(2) (West Supp. 1983), 1245(b)(3) (1976), 1250(d)(3) (1976).

### B. *Five-Year Period*

The elective element of section 334(b)(2) was not in itself a major problem; rather, abuses arose because P had too long (five years) to decide whether to "elect" the section's benefits.<sup>18</sup> If section 334(b)(2) were chosen, the acquired assets took a basis stepped-up to the basis of P's stock in T. The adjustment of P's date-of-liquidation basis in T stock, to reflect T's operations from the time P acquired the stock to the date of liquidation, was a complex process.<sup>19</sup> In the case of investment tax credit (ITC) recapture, the five-year period actually reduced by twenty percent the recapture cost of the section 334(b)(2) "election" due to the annual reduction of the ITC recapture.<sup>20</sup> During the five-year period before the target was finally liquidated and section 334(b)(2) was applied, P and T could file consolidated returns,<sup>21</sup> enabling P to utilize any favorable tax attributes<sup>22</sup> T possessed. This use of consolidated returns was allowed despite the general prohibition against such use when the benefits of

18 P had 12 months in which to acquire control over T (I.R.C. § 334(b)(2)(B)(i) (1976); if P wished to obtain the benefits of I.R.C. § 334(b)(2), P had to liquidate T within five years subsequent to acquiring control of T. But, if P did not liquidate T within the five-year period, he would obtain the benefits of I.R.C. § 334(b)(1) (1976).

19 I.R.C. § 334(b)(2) (1976); Treas. Reg. § 1.334-1(c)(4) (1982).

20 I.R.C. § 47(a)(5)(B) (West Supp. 1983). The investment tax credit is recaptured only if the asset is "disposed of" earlier than the time period used to compute the amount of the credit. If the taxpayer estimated the asset would last only three years, only 60% of its cost would qualify for the credit. If instead, the taxpayer said it would last five years, 100% of its cost would qualify for the credit. The recapture provision of I.R.C. § 47(a) (West Supp. 1983) was enacted to take back any credit to which the taxpayer was not ultimately entitled. For example, if the taxpayer had three-year property but said it was five-year property to qualify 100% of its cost for the credit, and then the taxpayer disposed of it after three years, the taxpayer must pay back the unearned credit arising from the incorrect estimate of its expected usefulness. The credit, then, is earned ratably over the property's estimated life at the rate of 20% per year. After it is used five years, there is no longer a chance of investment tax credit recapture with respect to that asset. Therefore, if P acquires control over T in the first year and takes an investment tax credit with respect to an asset, it would be immediately recaptured in full if T is liquidated and I.R.C. § 334(b)(2) (1976) is used. I.R.C. §§ 47(b)(2) (West Supp. 1983), 381(a) (1976). If P waits the full five years to liquidate T, there would be no recapture (I.R.C. § 47(a)(5)(B) (West Supp. 1983)) and the "cost" of the liquidation is cheaper. The "cost" is reduced by 20% for each year P waits to liquidate T.

21 A consolidated return can be used by an "affiliated group" of corporations rather than having each such corporation file separate returns. I.R.C. § 1502 (1976). Profits of one corporation can be offset by losses of another. To qualify as an "affiliated group" of corporations, a common parent must own brother-sister corporations (I.R.C. § 1504(a)(2) (1976)) or, as here, a parent must "control" a subsidiary (I.R.C. § 1504(a)(1) (1976)).

22 Tax attributes of a corporation include any net operating losses (NOL), earnings and profits (E & P), capital loss carryover, and the method of accounting employed. I.R.C. § 381(c)(1)-(4) (1976). These can be favorable to P if T has an NOL or capital loss carryover or a deficit in its E & P account. These attributes are usually succeeded to when assets are acquired in an I.R.C. § 332 (1976) (parent-subsidiary) liquidation. I.R.C. § 381(a) (1976).

section 334(b)(2) were sought.<sup>23</sup> Thus, notwithstanding Congress' intention to create mutually exclusive options for stepping-up or carrying over the basis in liquidations, corporations devised a hybrid system of tax treatment.

### C. *Selective Electivity*

In addition to the tax loopholes in the five-year election period, abuses also arose from the parent's ability to "selectively elect" which assets it wanted to fall within the ambit of section 334(b)(2). An acquiring corporation achieved selectivity by directly purchasing those of T's assets which, while highly-appreciated, had minor recapture costs. The direct purchase of such assets gave the purchaser a cost basis,<sup>24</sup> with little or no recapture cost to the vendor. The purchasing corporation then indirectly acquired the remaining assets of T with significant recapture costs. The parent acquired these "expensive" assets by purchasing the shares of T, avoiding the step-up rules of section 334(b)(2) upon liquidation.<sup>25</sup> By taking the recapture-heavy assets with a carryover basis, P was able to avoid all recapture costs attributable to the remaining assets. Additionally, the carryover basis rule of section 334(b)(1) enabled P to utilize favorable tax attributes of the acquired corporation.<sup>26</sup> With this hybrid approach, then, P was able to select which of T's assets it was willing to incur the recapture cost on to achieve a stepped-up basis.

The combined use of a stock acquisition and partial liquidation was another way to selectively elect which assets of a target were to receive stepped-up bases. The U.S. Steel/Marathon Oil takeover provides an example of this method. After U.S. Steel acquired Marathon's stock, the latter distributed a valuable asset in partial liquidation to U.S. Steel.<sup>27</sup> The partial liquidation rules enabled U.S. Steel to acquire the asset with a stepped-up basis,<sup>28</sup> but without

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The attributes are used indirectly without a liquidation when a parent and subsidiary file consolidated returns.

23 I.R.C. § 381(a) (1976) prohibited the use of T's tax attributes in an I.R.C. § 332 liquidation if the assets take a stepped-up basis under I.R.C. § 334(b)(2) (1976).

24 That is, an I.R.C. § 1012 (1976) cost basis.

25 If P preferred a carryover basis without recapture costs, the step-up basis rule of I.R.C. § 334(b)(2) (1976) was avoidable in a number of ways. See note 16 *supra*.

26 See notes 22-23 *supra*.

27 The asset was the Yates oilfield which had significant recapture costs largely attributable to intangible drilling costs and depreciation. U.S. Steel wanted the oilfield with a stepped-up basis so it could take much larger deductions in the future. H.R. 6295, 97th Cong., 2d Sess., 128 CONG. REC. 1928 (1982).

28 Prior to TEFRA, I.R.C. § 334(a) (1976) gave to property received in a distribution in

any gain recognition.<sup>29</sup> Although the only gain Marathon recognized was recapture income,<sup>30</sup> U.S. Steel and Marathon were able to file a consolidated return which permitted the depreciation recapture income to be deferred.<sup>31</sup> Moreover, the ITC recapture rule was inapplicable<sup>32</sup> and tax attributes relating to the other assets were available to U.S. Steel due to the consolidated return.<sup>33</sup> This scheme was reported to have resulted in as much as \$500 million in merger-related tax benefits in the first year alone.<sup>34</sup>

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a partial liquidation a basis equal to its date-of-distribution value. Treas. Reg. § 1.1502-31(b)(2)(i) (1972).

29 Treas. Reg. § 1.1502-14(b)(1) (1980).

30 Prior to TEFRA, I.R.C. § 336 (1976) generally granted nonrecognition treatment (other than recapture) to a corporation on the distribution of property in partial liquidation. I.R.C. § 311(d) (1976), which recognizes gain when appreciated property is used to redeem stock, did not apply because a partial liquidation was not a redemption of the stock surrendered.

31 Treas. Reg. §§ 1.1502-13(d)(1) (1972), 1.1502-14(c)(1) (1972).

32 Treas. Reg. § 1.1502-3(f)(2) (1972).

33 For example, Marathon continued to use its own method of accounting, Treas. Reg. § 1.1502-17 (1966). Marathon's net operating losses were available to U.S. Steel, Treas. Reg. § 1.1502-20 (1966); the consolidated group used consolidated capital gains or losses, Treas. Reg. § 1.1502-22 (1966).

34 *Tax Treatment of Corporate Mergers and Acquisitions, and of Certain Distributions of Appreciated Property, and Job Training Credit Proposal Hearings on S. 2687 Before the Senate Committee on Finance*, 97th Cong., 2d Sess. 59, 62 (1982) (statement of Sen. Metzenbaum) [hereinafter cited as *Senate Hearings*]. An abuse was also available in the scenario utilized by Mobil Oil and Esmark. Mobil wanted to acquire a subsidiary of Esmark (TransOcean Oil, Inc.). *Id.* Mobil acquired enough shares of Esmark to equal the value of TransOcean. Esmark then distributed TransOcean to Mobil in a partial liquidation of itself. Although Mobil received fair market value basis in TransOcean (I.R.C. § 334(a) (West Supp. 1983)), just as it would if it had directly purchased TransOcean (I.R.C. § 1012 (West Supp. 1983)), Esmark recognized only recapture income on the partial liquidation (I.R.C. § 336 (West Supp. 1983)) and not the full gain realized, as it would have had Esmark sold TransOcean directly (I.R.C. § 1001 (West Supp. 1983)). The tax savings to Esmark amounted to a reported \$100 million. *Id.* For a more complete description of how partial liquidations were used to abuse the corporate acquisition area, see Ward, *The TEFRA Amendments to Subchapter C Corporate Distributions and Acquisitions*, 8 J. CORP. L. 277, 284-86 nn.72-88 (1983).

The abuses prevalent in corporate acquisitions and mergers attributable to the use of partial liquidations were corrected by re-defining a partial liquidation as a § 302 redemption. Now a gain is recognized when appreciated assets are used in a partial liquidation, just as with any other redemption, unless the distributee is a noncorporate stockholder who held at least 10% of the distributor's stock for the preceding five years (or since the distributor's inception if in existence less than five years). I.R.C. §§ 311(d)(2)(B), (e)(1) (West Supp. 1983). Sale or exchange treatment is only available to noncorporate stockholders receiving assets in partial liquidation. I.R.C. § 302(b)(4) (West Supp. 1983).

It is curious that Congress apparently intended I.R.C. § 338 to override the new partial liquidation rules. In situations similar to the Mobil/Esmark scenario, several cases and I.R.S. rulings have declared that, in essence, the target sold the asset directly to the acquiring corporation and the target then distributed the proceeds to its stockholders, which proceeds were taxed as dividends unless I.R.C. § 302 applied. *See, e.g.,* *Idol v. Commissioner*, 38 T.C. 444 (1962), *aff'd*, 319 F.2d 647 (8th Cir. 1963), Rev. Rul. 80-221, 1980-2 C.B. 107. *But cf. Stan-*



In response to these incredible tax savings, Congress attempted to make the federal tax laws a more neutral factor in the decision of how one corporation acquires the assets of another. In the words of Senator Danforth, "what we want to get at is the United States Steel/Marathon Oil and Mobil/Esmark type of a situation."<sup>35</sup> In a relatively short period of time, a package was enacted which greatly revised the partial liquidation and indirect asset acquisition rules.<sup>36</sup>

### III. Section 338

Congress attempted to remedy the situation with the enactment of section 338 and the corresponding repeal of section 334(b)(2). Briefly, section 338 stipulates that if an acquiring corporation purchases control over a target, the parent must quickly elect whether the target's assets will continue with the same bases they had before the takeover, or whether the bases will be stepped-up to their fair market values. Provisions were enacted to ensure consistent treatment of all assets of the target and any target affiliates. In addi-

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dard Linen Service, Inc. v. Commissioner, 33 T.C. 1 (1959), *acq.*, 1960-2 C.B. 7 (tax considerations not the dominant reason for the form used). The Senate Report indicates that the amendment to I.R.C. § 311(d) (requiring gain recognition to the target corporation on assets used in partial liquidation) are "not intended to affect the treatment under present law of distributions that are in substance the purchase of assets." S. REP. NO. 494, 97th Cong., 2d Sess. 3, 190 (1982). If Corporation A purchases 40% of corporation B and then receives an appreciated asset (equal in value to the cost basis of the 40% of corporation B stock) in partial liquidation, new I.R.C. § 311(d) would recognize the entire gain realized because the partial liquidation is a redemption. The same result is attained if the transaction is viewed as an asset sale which, according to the Senate Report, is not within the ambit of I.R.C. § 311(d) because I.R.C. § 1001 would require full gain recognition. Assume instead P purchases at least 80% of T, does not elect I.R.C. § 338, and (within one year) receives an appreciated asset in partial liquidation for 40% of T's stock. Since pre-TEFRA law (and the I.R.S.) viewed this as a direct asset purchase, the Senate Report indicates I.R.C. § 311(d) does not apply. However, the acquisition will trigger a deemed I.R.C. § 338 election because P did not expressly elect I.R.C. § 338, yet did acquire an asset of T in a manner which triggers the consistency provisions of I.R.C. § 338(e). In that case, the deemed I.R.C. § 337 sale (I.R.C. § 338(a)) would only require the recognition of recapture income and not the entire gain realized as would have been required if the new I.R.C. § 311(d) rules controlled. Therefore, if the value of the asset or assets eventually to be received in partial liquidation is close to 80% of the entire value of the target, substantial savings can be achieved by purchasing and redeeming enough extra target stock to pull the transaction into I.R.C. § 338.

Although the TEFRA changes in the partial liquidation area constitute an important weapon to counteract abuses in the corporate acquisition and merger areas, the partial liquidation scheme will not be discussed further in this article.

35 *Senate Hearings, supra* note 34, at 160.

36 Rep. Stark, Chairman of the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, introduced H.R. 6295 on May 6, 1982. This bill was referred to as the Corporate Takeover Tax Act of 1982. Hearings were held on June 15, 1982 and the final draft was prepared on August 17, 1982. In all, Congress had barely more than three months to study the problem, work out solutions, and debug the Code.

tion, although a liquidation is not required to receive stepped-up treatment, section 338 provides that the parent cannot use any of the target's tax attributes if the asset bases are stepped-up.

### A. *Section 337 Sale*

When an acquiring corporation makes a "qualified stock purchase" of a target,<sup>37</sup> it can elect within seventy-five days to qualify the whole transaction for stepped-up treatment under section 338.<sup>38</sup> To further equate the tax treatment accorded direct and indirect asset purchases, both methods now involve section 337.<sup>39</sup> If the benefits of section 338 are elected, T is treated as having sold all of its assets on the date of "acquisition" pursuant to section 337,<sup>40</sup> and a "new" T is treated as having purchased the assets on the day after the "acquisition."<sup>41</sup> Generally, if P acquires all the stock of T, the section 337 sale is deemed to have occurred at a price equal to the basis of P's stock in T, properly adjusted for liabilities.<sup>42</sup> In essence, the sales price is equal to the assets' fair market value.<sup>43</sup>

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37 A qualified stock purchase is similar to the 80% control test required prior to TEFRA for application of I.R.C. § 334(b)(2). In essence, the parent must acquire at least 80% of the target by "purchase" within a 12-month period, even if the parent already owned some stock in the target prior to the 12-month period in which an additional 80% is acquired. I.R.C. §§ 338(d)(3), (h)(1)-(3) (West Supp. 1983).

38 Unlike I.R.C. § 334(b)(2), I.R.C. § 338 requires an express election (I.R.C. § 338(g)), although P can be deemed to have made an election under certain circumstances. See notes 57-63 *infra* and accompanying text. An election is irrevocable. I.R.C. § 338(g)(3) (West Supp. 1983). In addition, I.R.C. § 338 may be elected even if the intent of the stock purchases was not to acquire the target's assets. If the acquiring corporation wishes to receive a stepped-up basis but does not satisfy the requirements, there is no other method by which the parent can receive a step-up. The parent cannot argue it "intended" to purchase the stock solely to acquire the target's assets because the Senate Report makes it clear that I.R.C. § 338 was intended to replace any non-statutory treatment of a stock purchase as an asset purchase under the *Kimbell-Diamond* doctrine. S. REP. NO. 494, at 192.

39 With the direct method, P purchases the assets directly from T in an I.R.C. § 337 liquidation so there can be no non-recapture gain recognized. See note 3 *supra*.

40 I.R.C. § 338(a)(1) (West Supp. 1983). The acquisition date is the date on which P first satisfies the 80% test of I.R.C. § 338(d)(3). I.R.C. § 338(h)(2) (West Supp. 1983).

41 I.R.C. § 338(a)(2) (West Supp. 1983).

42 I.R.C. § 338(b) (West Supp. 1983).

43 For example, if T's assets are worth \$100 but are subject to liabilities of \$20, P would not pay \$100 for T's stock, but rather \$80. Therefore, P's basis in T's stock is \$80, but to determine the I.R.C. § 337 sales price, the basis must be adjusted to reflect the \$20 of liabilities. T will be deemed to have received an amount realized of \$100 and new T will have a basis in the assets equal to \$100. In situations where P does not acquire 100% control of T, the Code provides a method for determining what P would have paid for T's shares if P had in fact acquired complete control of T. This "grossed-up" basis is determined by multiplying P's basis in T stock by 100% and dividing by the percentage of T stock P did acquire. Continuing the same example, if P had only acquired 80% of T for \$64, the grossed-up basis of P's

The purpose of the deemed section 337 sale is to require that T recognize the same recapture costs it would have recognized had T sold all of its assets directly to P in the course of a section 337 liquidation.<sup>44</sup> In addition, the section 337 sale gives "new" T a section 1012 cost basis in the assets. P then owns stock in "new" T; all of "new" T's assets have a fair market value basis. Because of the repeal of section 334(b)(2), a subsequent liquidation of T<sup>45</sup> would fall within the general rules of sections 332, 334(b)(1), and 336. That is, neither P nor T would recognize gain or loss on the liquidation, and the assets received from T would take carryover (though fair market value) bases.

### B. *Prohibition Against Use of Consolidated Returns*

Prior to the enactment of section 338, the acquiring corporation could offset recapture income with any losses or credits it obtained through the use of a consolidated return.<sup>46</sup> This loophole was of major concern to Congress. Section 338 grants the Commissioner broad regulatory power to ensure that the purposes of the section are not circumvented through the use of law or regulation, including the use of consolidated returns.<sup>47</sup> The Conference agreement clearly states that the recapture income from the deemed section 337 sale is to be reported on the return of the "old" target. The tax year of the "old" target ends "on the date of acquisition and it does not become a member of the affiliated group including the acquiring corporation until the day following the date of acquisition."<sup>48</sup> Only the "new" target becomes a member of the acquiring corporation's affiliated group.<sup>49</sup> This amendment should further the goal of equating the amount of recapture recognized in a purchase of stock/liquidation and its functional equivalent, the direct asset purchase. For example, the recapture income recognized by "old" T cannot be offset by any

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stock in T would be  $\$64 \times (100\% \div 80\%) = \$80$ . When adjusted for liabilities, the deemed purchase price would again be \$100.

44 S. REP. NO. 494, at 192-93.

45 A liquidation of T is not required if I.R.C. § 338 is elected. This ability to step-up asset bases without forcing a liquidation is one of the major benefits of I.R.C. § 338. Liquidations can be costly and time consuming. Many times it is impossible or impractical to obtain assignments for leases, patents, or employment contracts. The opportunity to avoid liquidation costs and problems without a concurrent loss of tax alternatives enhances the attractiveness of I.R.C. § 338.

46 *Senate Hearings*, *supra* note 34, at 74, 81 (statement of David G. Glickman, Deputy Assistant Secretary of the Treasury for Tax Policy).

47 I.R.C. § 338(i) (West Supp. 1983).

48 S. REP. NO. 494, at 193.

49 H. CONF. REP. NO. 760, 97th Cong., 2d Sess. 409, 539 (1982).

of P's losses or credits, nor can P utilize T's favorable tax attributes, since P and T would not be affiliates and could not file a consolidated return.

### C. *Explicit Election*

Unlike the procedure of section 334(b)(2), section 338 requires an express election within seventy-five days of the acquisition date.<sup>50</sup> This requirement will greatly benefit the tax law in the corporate acquisition area. The complex basis adjustments formerly required in section 334(b)(2)<sup>51</sup> are no longer necessary, and it is impossible for P to reduce the ITC recapture "cost" of the acquisition by delaying the "election."<sup>52</sup>

The requirement that the election be made within seventy-five days is unwarranted, however. If an election is made, the section 337 sale is deemed to have occurred on the acquisition date, not on the election date.<sup>53</sup> The sale price is also determined with reference to the acquisition date.<sup>54</sup> Therefore, the parent gains nothing by delaying an election beyond the time prescribed.<sup>55</sup> The election period should be extended to allow more time for an informed decision.

### D. *Consistency Provisions*

Another major weakness of section 334(b)(2), was a corporation's ability under that section to selectively elect which assets would be stepped-up by combining direct and indirect asset purchases. Alternatively, selectivity could also be accomplished by transferring high recapture assets to a subsidiary of the target. P then purchased the subsidiary directly from T, purchased T, and then liquidated both target affiliates, using the basis rule of section 334(b)(2) for the target with the "inexpensive" assets and section 334(b)(1) for the subsidiary with the "expensive" assets. Another example of selectivity involved the use of partial liquidation.<sup>56</sup>

Many felt that an "all-or-nothing" approach would be preferable to the "selectivity" of section 334. Under the all-or-nothing ap-

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50 I.R.C. § 338(g) (West Supp. 1983).

51 I.R.C. § 334(b)(2) (West Supp. 1983); Treas. Reg. § 1.334-1(c)(4), T.D. 6152, 1955 C.B. 61, 143-45.

52 See note 20 *supra*.

53 I.R.C. §§ 338(a)(1), (b)(1)(A) (West Supp. 1983).

54 I.R.C. § 338(b)(1)(A) (West Supp. 1983).

55 Letter from Lawrence Lokken (Editor-in-Chief, *Tax Law Review*) to R. Lawrence Heinkel (March 11, 1983) (discussing the 75 day election period of § 338).

56 See notes 27-34 *supra* and accompanying text.

proach, if P wants to step-up one asset it must also step-up the bases of all other assets acquired from T and incur the proper recapture costs.<sup>57</sup> To effectuate this philosophy, Congress enacted the "consistency provisions."<sup>58</sup> These provisions were designed to prevent selectivity in asset acquisitions by forcing acquiring corporations to elect section 338 if they make qualified stock purchases<sup>59</sup> and acquire any asset of the target corporation or one of its affiliates<sup>60</sup> during the consistency period.<sup>61</sup> Consistency is also required if the acquiring com-

57 Although many groups and individuals have expressed their support for the "all-or-nothing" approach (see, e.g., *Senate Hearings, supra* note 34, at 74, 85 (statement of David G. Glickman, Treasury)), Professor Ginsburg has expressed a somewhat different view. In his opinion, the serious problem was not that acquiring corporations could selectively step-up the basis of one asset or assets and not others, but that "sophisticated corporate buyers" have been able to avoid or defer paying the recapture "charge" on those assets which the corporation did choose to step-up. *Senate Hearings, supra* note 34, at 125, 151 (statement of Martin D. Ginsburg, Professor of Law, Georgetown University Law Center). As he put it, "present law was operating in a manner inconsistent with underlying tax policy." *Id.*

58 I.R.C. §§ 338(e), (f) (West Supp. 1983).

59 I.R.C. § 338(d)(3) (West Supp. 1983). A qualified stock purchase is a transaction or series of transactions in which P acquires 80% control of T during a 12-month period. If P acquires such control of T during a longer period of time, it will not be a qualified stock purchase and P cannot elect I.R.C. § 338. However, P may still be deemed to have so elected if the purpose of taking longer than 12 months to acquire control was part of a plan to avoid I.R.C. § 338. I.R.C. § 338(e)(3) (West Supp. 1983).

60 A corporation is a target affiliate of T if each was, at any time during so much of the consistency period as ends on the date of acquisition, a member of an affiliated group (within the meaning of I.R.C. § 1504(a), determined without regard to exceptions contained in I.R.C. § 1504(b)) having the same common parent. I.R.C. § 338(h)(5)-(6) (West Supp. 1983). This is designed to curb the abuse of dispersing the different assets of T into subsidiaries. Therefore, if P acquires only sub-1 from T and does not elect I.R.C. § 338, P cannot acquire the assets of sub-2 without being deemed to have elected I.R.C. § 338 with respect to sub-1. I.R.C. § 338(e)(1) (West Supp. 1983). Without this provision, P could liquidate sub-1 using I.R.C. § 334(b)(1) (acquiring a carryover basis in the assets and avoiding recapture costs on the assets of sub-1), and purchase desired assets directly from sub-2 to achieve low-cost, stepped-up bases. Likewise, if P were to acquire sub-1, without electing I.R.C. § 338, and within one year purchase assets directly from sub-1, P would be deemed to have made the I.R.C. § 338 election as of the acquisition date. I.R.C. § 338(e)(1) (West Supp. 1983).

There are several types of asset acquisitions which would not trigger a deemed election. The exceptions are for sales in the ordinary course of business (I.R.C. § 338(e)(2)(A)); assets with a carryover basis to P (I.R.C. § 338(e)(2)(B)); pre-September 1, 1982 acquisitions (I.R.C. § 338(e)(2)(C)); assets located outside the United States (I.R.C. § 338(e)(2)(D)); and others to be prescribed by the Service (I.R.C. § 338(e)(2)(E)).

61 The consistency period is so much of the 12-month acquisition period which has expired before the 80% test is met, plus one year before and one year after. I.R.C. § 338(h)(4) (West Supp. 1983). For example, if P makes its first "purchase" of T stock on January 1, 1984, it has until December 31, 1984 to acquire 80% control for the acquisition to constitute a qualified stock purchase. I.R.C. §§ 338(d)(3), (h)(1)-(3) (West Supp. 1983). If, however, such control is acquired on March 1, 1984, and P purchases the last 20% of T on September 1, 1984, the consistency period consists of January 1, 1983, to January 1, 1984, plus the acquisition period of January 1, 1984, to March 1, 1984, and also the one-year period from March 1, 1984, to March 1, 1985. Thus, the consistency period can be as short as two years (if control is

pany purchases a corporation and subsequently acquires an affiliate within the consistency period. Whether or not section 338 was elected for the first acquisition, consistent treatment must be accorded the second acquisition.<sup>62</sup> Congress believes that these consistency requirements will eliminate many of the abuses involving combinations of asset purchases with stock purchases.<sup>63</sup>

#### IV. Problems with Section 338

Although the rationale behind the repeal of section 334(b)(2) and enactment of section 338 is laudable, the legislation was aimed at specific abuses of the corporate tax laws by large, multi-national corporations.<sup>64</sup> Highly publicized cases illustrated the extent of tax loopholes concerning corporate acquisitions, and these loopholes became the target of those committees charged with the responsibility of increasing the tax revenues.<sup>65</sup> Legislation was quickly drafted;<sup>66</sup> weaknesses remain in the corporate acquisition area of the Internal Revenue Code.

##### A. *Explicit Election*

Section 338(g) requires an election within seventy-five days of the acquisition date.<sup>67</sup> Requiring a quick election does away with both the old five-year period<sup>68</sup> and the complex basis adjustments which were required under section 334(b)(2).<sup>69</sup> However, before an

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acquired in a single transaction) or as long as three years (if control is established on the last day of the 12-month acquisition period). In addition, the Service is empowered to extend the consistency period in either direction if an earlier or later purchase of an asset is part of a plan to avoid I.R.C. § 338. I.R.C. § 338(h)(4)(B) (West Supp. 1983).

62 If P were to acquire sub-1 and, during the consistency period, also make a qualified stock purchase of sub-2, any decision to elect or not elect I.R.C. § 338 with respect to the first sub is binding on the second. I.R.C. § 338(f) (West Supp. 1983).

63 The consistency requirements have been described as "a rational, logical and workable solution to the problems involved in selectivity." *Senate Hearings, supra* note 34, at 74, 85 (statement of David G. Glickman, Treasury).

64 See text accompanying note 35 *supra*.

65 The Joint Committee on Taxation recommended revisions in the corporate acquisition area as a way to plug certain loopholes and raise between \$500 million and \$1 billion annually with even their limited revision suggestions. JOINT COMMITTEE ON TAXATION WITH THE STAFF OF THE SENATE COMMITTEE ON FINANCE, 97TH CONG., 2D SESS., DESCRIPTION OF POSSIBLE OPTIONS TO INCREASE REVENUES 103-07 (Joint Comm. Print, June 15, 1982).

66 See note 36 *supra*.

67 The acquisition date is the first day on which the parent has made a qualified stock purchase. I.R.C. § 338(h)(2) (West Supp. 1983).

68 See notes 18-23 *supra* and accompanying text.

69 For a discussion of the complex basis adjustments required by I.R.C. § 334(b)(2) and

election decision can be reached, P must determine the amount of recapture on the section 337 sale, the proper basis allocation among the assets, and whether the present value of the additional depreciation deductions attributable to the stepped-up basis exceeds the "cost" of those deductions.<sup>70</sup> These calculations take time and seventy-five days may be too brief, especially in light of the fact that an election with respect to T would be binding on all T affiliates acquired within the consistency period.<sup>71</sup> Furthermore, because all calculations are based on facts as they existed on the acquisition date, a longer election period cannot benefit the parent corporation, except insofar as it permits a more careful and informed decision.<sup>72</sup>

Initially, it appears that failure to elect section 338 within seventy-five days precludes its benefits forever. If P were to fail to elect section 338, however, it could obtain the benefits of a deemed election by purchasing an asset of T within the consistency period.<sup>73</sup> Nevertheless, the conference agreement provided the Internal Revenue Service with authority to preclude a deemed election where P makes a *de minimis* purchase of T's assets to avoid the short seventy-five day time limit.<sup>74</sup>

### B. Consistency Provisions

Congress enacted consistency provisions<sup>75</sup> designed to implement the all-or-nothing rule. Under Section 338, if P makes a qualified stock purchase of T and elects not to step-up T's assets, T is nonetheless deemed to have elected step-up treatment if any of T's other assets are acquired<sup>76</sup> at any time during the consistency pe-

Treas. Reg. § 1.334-1(c)(4)(i)-(iv) (1982), see Bonovitz, *Current Liquidation Problems Under Section 334(b)(2) and Section 337 Distributions and Reserves*, 30 INST. ON FED. TAX'N 1095, 1135 (1972).

70 Battle, *Section 338 — Stock Purchases Treated as Asset Purchases for Tax Purposes*, 60 TAXES 980, 982-83 (1982).

71 I.R.C. § 338(f)(1) (West Supp. 1983). See also *Senate Hearings*, *supra* note 34, at 257, 264 (statement of Earl C. Brown, Arthur Andersen & Co.); *id.* at 267, 278 (statement of Herbert J. Lerner, Ernst & Whinney).

72 See note 55 *supra*. On the other hand, a properly prepared corporation would not find itself in a I.R.C. § 338 situation without much advanced planning and preparation. It is arguable that a corporation which has done its homework would not need 75 days to decide whether to make the election.

73 I.R.C. § 338(e)(1) (West Supp. 1983).

74 H. CONF. REP. NO. 760, 97th Cong., 2d. Sess. 409, 540. In addition, failure to timely elect I.R.C. § 338 cannot be cured by liquidating the target. Because old I.R.C. § 334(b)(2) has been repealed, the assets would receive a carryover basis on the liquidation. I.R.C. § 334(b)(1) (1976).

75 See notes 58-63 *supra* and accompanying text.

76 Some acquisitions do not trigger a deemed election. See note 60 *supra*.

riod.<sup>77</sup> For example, if P makes a direct asset purchase of one or more of T's assets and makes a qualified stock purchase of T within the next two years, P will be deemed to have elected section 338 whether or not it actually elects the section.<sup>78</sup> An election is also deemed if, after making a qualified stock purchase of T, P directly purchases assets from T within one year.<sup>79</sup>

Consistency is also required of target affiliates<sup>80</sup> which a single corporation acquires. If T has two or more subsidiaries and P purchases two or more of them during any consistency period, an election with respect to the first such purchase is binding on the other purchases.<sup>81</sup> If no election was made with respect to the first such purchase, P is precluded from electing for any subsequent purchase.<sup>82</sup>

The consistency requirement for target affiliates has been attacked as unnecessary. Critics maintain that the requirement is based on the false assumption that without it potential targets could rearrange their affairs by placing undesired, recapture-heavy assets in a subsidiary.<sup>83</sup> Others have urged that other provisions of the Code are sufficient to attack the rearrangement,<sup>84</sup> or that, since the creation of the subsidiary is part of an overall plan to defeat the intent of section 338, the subsidiary would be ignored.<sup>85</sup> Furthermore, section 338(f) requires consistency of treatment for corporations of the same "affiliated group."<sup>86</sup> Therefore, only if target corporations A and B are owned by the same corporation must P consistently apply section 338. If corporations A and B are owned by an individual or partner-

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77 I.R.C. § 338(e) (West Supp. 1983).

78 If P takes the full 12 months allowed to make a qualified stock purchase of T, the consistency period would include both such 12-month period and the preceding one year (for a two-year period) in which P can make a qualified stock purchase and have the earlier direct purchase trigger the I.R.C. § 338 election. I.R.C. §§ 338(d)(3), (e)(1), (h)(4) (West Supp. 1983).

79 I.R.C. § 338(e)(1) (West Supp. 1983).

80 Two or more corporations are target affiliates if each was, at any time from the beginning of the consistency period until a qualified stock purchase has been made, a member of an affiliated group having the same common parent. I.R.C. § 338(h)(6) (West Supp. 1983).

81 I.R.C. § 338(f)(1) (West Supp. 1983).

82 I.R.C. § 338(f)(2) (West Supp. 1983).

83 *Senate Hearings, supra* note 34, at 167, 174 (statement of Herbert L. Camp, New York State Bar Association Tax Section).

84 *Id. See, e.g.*, I.R.C. § 269 (1976).

85 *See, e.g.*, Telephone Answering Serv. Co. v. Commissioner, 63 T.C. 423 (1974), *aff'd*, 546 F.2d 423 (4th Cir. 1976), *cert. denied*, 431 U.S. 914 (1977) (no complete liquidation where some assets remain in corporate solution after the transaction).

86 I.R.C. § 338(h)(5) (West Supp. 1983) defines "affiliated group" as that term is used in I.R.C. § 1504(a) (1976).



ship, or are unrelated corporations, P can acquire both without complying with the consistency requirement.

One way to defeat this consistency requirement in the close corporation setting would be for P's sole stockholder C to purchase sub-B from T, and for P to purchase sub-A from T. P could then liquidate sub-A and receive a step-up in basis. The consistency requirement of section 338(f) would not apply with respect to C's ownership of sub-A.<sup>87</sup> Another method would entail C purchasing the stock of sub-B with money borrowed from a bank. C could then form a holding company (D) and contribute both the shares in B and P (and note that P, in the meantime, has acquired the stock of A) in return for all the shares of D and D's assumption of the acquisition indebtedness. Sole stockholder C would not be taxed on D's assumption of the acquisition indebtedness<sup>88</sup> and, after P elected section 338 with respect to A, corporations P, D and B could file consolidated returns.<sup>89</sup> There are undoubtedly other ways to avoid the consistency requirements of section 338 which the Secretary may be able to cure with additional regulations.<sup>90</sup>

### C. *Extensive Regulatory Authority Granted*

To help combat the abuses of section 334(b)(2) and ensure that the remedies are not avoided through manipulative tactics, Congress has granted the Service broad authority to issue regulations in ten areas of possible abuse.<sup>91</sup> It is most unusual for Congress to grant the Service such extensive rule-making power; until regulations are

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87 This avoidance scheme has also been proffered by Professor Ginsburg. See, Ginsburg, *TEFRA: Purchase and Sale of a Corporate Business*, ALI/ABA Course Study on TEFRA, co-sponsored by the Section of Taxation of the American Bar Association, 379, 459 (1982). [hereinafter cited as *Course Study*].

88 I.R.C. § 304(b)(3)(B) (West Supp. 1983).

89 *Course Study*, *supra* note 87, at 459.

90 *Id.* at 459-60. However, it is arguable that I.R.C. § 338 would reach even these transactions even though P did not acquire the other assets directly from T during the consistency period, because the statute simply requires consistent treatment if the parent acquires assets of the target. I.R.C. § 338(e)(1) (West Supp. 1983).

91 I.R.C. § 338(b)(3) (West Supp. 1983) (allocation of basis among assets); I.R.C. § 338(e)(2)(D) (West Supp. 1983) (exception from consistency rules for assets located without the United States); I.R.C. § 338(e)(2)(E) (West Supp. 1983) (other exceptions from the consistency rules); I.R.C. § 338(e)(3) (West Supp. 1983) (anti-avoidance rule for the consistency rules); I.R.C. § 338(g)(1) (West Supp. 1983) (timing of the election); I.R.C. § 338(g)(2) (West Supp. 1983) (manner of electing); I.R.C. § 338(h)(4)(B) (West Supp. 1983) (extension of consistency period if pursuant to a plan); I.R.C. § 338(h)(6)(B) (West Supp. 1983) (definition of target affiliate as it pertains to foreign corporations); I.R.C. § 338(h)(7) (West Supp. 1983) (acquisitions by purchasing corporation's affiliates); and I.R.C. § 338(i) (West Supp. 1983) (general anti-avoidance).

promulgated, section 338 provides no certainty to the tax planner. This weakness in Congress' remedy could have been avoided by a more thorough consideration of the problems leading to the enactment of section 338.<sup>92</sup>

#### D. Other Problems

Since the Service has extensive rule-making authority, there are many questions which the language of section 338 does not answer. Until regulations are proposed, taxpayers must contend with such uncertainties as: the effect a contingent selling price will have on both asset basis and recapture income; the impact of a subsequent price reduction in the shares of T which P acquired; and the effect of additional stock purchases after a qualified stock purchase has been made.<sup>93</sup>

#### V. Proposals in Lieu of Section 338

The corporate acquisition and merger area of the Code was in great need of reform. Abuses cost the Treasury hundreds of millions of dollars each year.<sup>94</sup> Section 338 went a long way toward curing the ills of section 334(b)(2);<sup>95</sup> however, some problems remain.

Section 338 is extremely long and complicated.<sup>96</sup> The following proposals are designed to implement the goal of section 338 in a manner that is as easy to understand as possible. To begin with, section 338 should be repealed in its entirety. Its goal<sup>97</sup> can be accomplished with simpler, less intrusive Code amendments. Section 334(b)(2) should be revitalized with several minor changes. The simplicity of these proposals would be greatly appreciated by the tax bar.

Note that Congress did not seek to affect the situation in which a corporation liquidated a subsidiary it had acquired many years prior to the liquidation. Rather, Congress sought to attack corporations

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92 For a general discussion of the impact of the broad regulatory authority granted the Service, see Battle, *supra* note 70, at 992-93; Silverman & Serling, *An Analysis of the TEFRA Changes Affecting Corporate Distributions and Acquisitions*, 57 J. TAX'N 274, 276 (1982).

93 These and other issues were raised by Professor Ginsburg in *Course Study*, *supra* note 87, at 441-45.

94 See note 34 *supra* and accompanying text.

95 See note 93 *supra*.

96 It has been argued that parts of I.R.C. § 338, in particular the consistency requirements, simply will not work in practice. See *Senate Hearings*, *supra* note 34, at 125, 153 (statement of Professor Ginsburg).

97 The goal is to equate, as nearly as possible, the tax results in an asset transaction and a stock transaction. *Id.* at 145.

which purchased targets and liquidated them with the sole purpose of acquiring their assets.<sup>98</sup> There should be a difference, then, in the tax treatment accorded a parent liquidating a recently-acquired subsidiary versus one liquidating a subsidiary it formed or acquired at some previous time. Preferential treatment should be given to all corporations which "purchased" or formed the subsidiary at least five years previous to the liquidation date. The following proposals<sup>99</sup> refer only to corporations which have "purchased" or formed the subsidiary more recently than within the last five years.

#### A. *Explicit Election*

The present seventy-five day election period for stepped-up basis should be lengthened to about 150 days and accompanied by a mandatory twelve-month (or shorter) liquidation period. The shorter election and liquidation periods will offer the same benefits they provide in section 338.<sup>100</sup> The complex basis adjustments would be unnecessary because of the shorter time between acquisition and liquidation. Additionally, the consolidated return regulations should be amended so that P and T are not entitled to file these returns if section 334(b)(2) is elected. This amendment will prevent a meshing of tax attributes during the interim between election and liquidation. The recapture costs for the privilege of stepped-up basis would have to be currently paid and not deferred or avoided entirely, as was previously possible.<sup>101</sup>

#### B. *Target's Tax Attributes*

Because T's tax attributes would not be available if P had purchased T's assets directly, and since the purpose of the proposed changes in section 334(b)(1) and (2) is to equate the tax treatment of direct and indirect asset acquisitions (whether or not P takes some assets with carryover bases), T's tax attributes should not be available regardless of which provision is used. Each provision calls for basis calculation when the purpose of the stock acquisition and liquidation is to acquire the assets indirectly. But under section 334(b)(1), the tax attributes carry over to the recipient. With the proposed amendments, however, section 334(b)(1) allows a different result if the subsidiary has been held by the parent for at least five years. The

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98 See text accompanying note 35 *supra*.

99 See § V(E) *infra*.

100 See notes 51 and 52 *supra* and accompanying text.

101 See text accompanying notes 20-23 *supra*.

parent can only utilize the target's tax attributes if the subsidiary has been held for five years or longer.

### C. *Consistency with Target's Assets*

P's ability to combine asset and stock purchases was one of the major concerns of section 334(b)(2). If Congress did not want P to selectively recognize recapture income, instead desiring an all-or-nothing approach, this objective could have been easily accomplished by requiring recapture even when T's assets take a carryover basis. Section 334(b)(1), which normally gives assets a carryover basis without recapture recognition, should be amended to require the same recapture recognition as is required when assets receive a step-up under section 334(b)(2). The carryover basis should be increased by the amount of recapture income which must be recognized. This way, whether P wants a carryover basis<sup>102</sup> or fair market value basis<sup>103</sup> in T's assets, recapture would have to be recognized and could not be avoided by purchasing some assets directly and others indirectly.

### D. *Consistency with Target Affiliates*

Perhaps the biggest obstacle to constructing a simplified alternative to section 338 is determining what kind of treatment to accord the purchase of more than one corporation of the same affiliated group (i.e., brother-sister corporations). The existence of two diametrically opposed theories on the proper treatment of brother-sister corporations further complicates the problem.

Congress adopted the first theory, denominated the all-or-nothing approach, in section 338(f).<sup>104</sup> This section requires consistent treatment in the application of section 338 to target corporations acquired from the same affiliated group during the consistency period. Section 338 mandates an election for the second-acquired corporation if an election was made for the first-acquired corporation.<sup>105</sup> Correspondingly, if no election has been made for the first corporation, one cannot be made for the second corporation.<sup>106</sup>

Thus far, the proposed revisions are not equipped to implement the all-or-nothing approach. As it stands, P can acquire S-1 and S-2

102 I.R.C. § 334(b)(1) (West Supp. 1983).

103 I.R.C. § 334(b)(2) (West Supp. 1983).

104 I.R.C. § 338(f) (West Supp. 1983).

105 I.R.C. § 338(f)(1) (West Supp. 1983).

106 I.R.C. § 338(f)(2) (West Supp. 1983).

(brother corporations of the same affiliated group) and elect section 334(b)(2) with respect to one, without regard to whether an election had been or will be made for the other. To appease the all-or-nothing advocates, some provision might have to be added requiring a consistent application to target affiliates. Such an amendment would complicate the proposed statutory scheme beyond the degree desired, however.

The following amendment would add paragraph (5) to pre-TEFRA section 334(b):

(5) *Consistency Required for all Stock Acquisitions from Same Affiliated Group.* (A) If an acquiring corporation satisfies the requirements entitling it to an election under paragraph (2) of subsection (b) above with respect to two or more target corporations of the same affiliated group as another target corporation with respect to which an election under this section has been made, and the requirements are satisfied within one year of the date such election was made, then elections will be deemed to have been made with respect to such target corporations which were purchased during such one-year period.

(B) If an acquiring corporation satisfies the requirements entitling it to an election under paragraph (2) of subsection (b) above with respect to two or more target corporations of the same affiliated group as another corporation for which the acquiring corporation was entitled to make an election under paragraph (2) of subsection (b) but which election was not made, and the requirements are satisfied within one year of the date on which the election option expired, then no election may be made with respect to such target corporations which were purchased during such one-year period.

But this amendment, while implementing the all-or-nothing rule in the current section 338, suffers from the same infirmities as section 338(f): it is based on an erroneous assumption about the tax policy regarding brother-sister acquisitions. The all-or-nothing theory is premised on the idea that if P wants a step-up in basis in some of T's assets (whether that step-up be to the fair market value or carryover basis, in the case of depreciated assets), P should be required to take a step-up in all assets of T that it acquires.

There is no sound policy justifying consistent treatment of two subsidiaries, S-1 and S-2, if T has historically operated distinct businesses in subsidiary form. Without a doubt, if T owns a bakery company whose major assets consist of a building and equipment, P should not be able to step-up the basis in the building without also stepping-up the basis in the equipment, regardless of the recapture costs. However, if T operates two distinct businesses, such as a

bakery and a theme park, the justification for making P pay the "toll charge" of recapture costs on both if it only wants an increased basis in the theme park is much less compelling.<sup>107</sup> And the rationale is equally weak whether the separate businesses are operated as divisions or through subsidiaries. The anti-selectivity or consistency provisions of proposed section 334(b)(5) (and sections 338(e) and (f)) require consistency for all businesses of the target corporation, not just the assets within one business.

The all-or-nothing approach should be rejected as inconsistent with sound corporate tax policy.<sup>108</sup> Selectivity was not a problem because the assets of S-1 were stepped-up while those of S-2 were not; rather, the gist of the problem was that "sophisticated corporate buyers have been able to use the provisions of (pre-TEFRA) law to defer or wholly avoid paying the toll charge tax on the assets that are stepped-up."<sup>109</sup>

The consistency requirement should also be rejected because it will not work in practice.<sup>110</sup> The consistency provisions of section 338(f) and proposed section 334(b)(5) can be avoided with clever planning.<sup>111</sup> For instance, in the close corporation setting, P can purchase some of T's assets directly, acquiring a stepped-up basis in them. P's sole stockholder can purchase T's shares which he can then contribute to P in a section 351 transaction so that P will receive the shares with a carryover (although fair market value) basis. P can then acquire the remaining assets of T indirectly through a liquidation, applying section 334(b)(1). Although this section requires a carryover basis, that basis is equal to the assets' fair market value. A combination of direct and indirect asset acquisitions would result, yet section 338 (or proposed section 334(b)(5)) would not prevent the abuse because P would not have acquired the stock from its stockholder by "purchase."<sup>112</sup>

One might dismiss the above abuse as allowable since section

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107 See *Senate Hearings*, *supra* note 34, at 125, 148 (statement of Professor Ginsburg).

108 *Id.* at 150-51.

109 *Id.* at 151. See also *Senate Hearings*, *supra* note 34, at 167, 173 (statement of Herbert L. Camp, New York State Bar Association Tax Section).

110 *Senate Hearings*, *supra* note 34, at 153.

111 For examples of how I.R.C. § 338(f) and proposed I.R.C. § 334(b)(5) can be avoided, see notes 83-90 *supra* and accompanying text.

112 The definition of "purchase" as provided in both I.R.C. § 334(b)(3) and I.R.C. § 338(h)(3) excludes an acquisition where the stock was acquired in an I.R.C. § 351 exchange (I.R.C. §§ 334(b)(3)(B) (West Supp. 1983), 338(h)(3)(A)(ii) (West Supp. 1983)), or if the basis of the stock in the hands of the parent is determined in whole or in part by reference to the basis such stock had in the hands of the person from whom it was acquired. I.R.C. § 334(b)(3)(A) (West Supp. 1983) and § 338(h)(3)(A)(i) (West Supp. 1983).

338 is not aimed at close corporations.<sup>113</sup> Nevertheless, even corporate giants can avoid the clutches of the consistency requirements through various techniques. For example, consistency can be avoided through the use of leasing arrangements, reorganizations, recapitalizations and Subchapter S corporations.<sup>114</sup>

Consistency provisions suffer from two drawbacks: they are easily avoided and are unsound from a policy standpoint. They should be abolished. Without section 338(f) or proposed section 334(b)(5), P can treat one bona fide target affiliate independently of the other.

#### E. *Exception for Non-aggressors*

These proposals apply to acquiring corporations which purchase and liquidate targets to acquire assets. The amendments require "toll charges" on all acquired assets, whether they were purchased directly or indirectly and whether bases are carried-over or stepped-up. The changes are also designed to prevent the deferral or outright avoidance of recapture costs through the use of consolidated returns. Just as tax attributes are not available to a direct purchaser of assets, they would not be available if P liquidates a target within five years of the "purchase."

These proposals do not apply to non-aggressor corporations which hold subsidiaries as a means to operate a business.<sup>115</sup> Thus any liquidation of a subsidiary which has been controlled for at least five years should be allowed without the necessity of recognizing recapture income. If the parent has controlled the subsidiary for five years, section 334(b)(2) is unavailable. Therefore, only section 334(b)(1) would be available and the assets could be received with a carryover basis but without recapture recognition.<sup>116</sup> If the parent does not liquidate its target but instead continues to own the target in subsidiary form after the fifth anniversary of its purchase or formation, the tax attributes of the subsidiary would be available to the parent; both the parent and subsidiary could then begin to file consolidated returns.

### VI. Conclusion

Although section 338 was a noble attempt to cure the ills of sec-

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113 See text accompanying note 35 *supra*.

114 *Senate Hearings*, *supra* note 34, at 125, 154-57 (statement of Professor Ginsburg); *Course Study*, *supra* note 87, at 379, 459-60, 462-70.

115 See text accompanying notes 98-99 *supra*.

116 See note 17 *supra* and accompanying text.

tion 334(b)(2), its complexity and vulnerability compounded those problems. The proposals of this article are comparatively easy to understand and implement, and better equipped to handle the problems section 338 was intended to solve.

The proposals distinguish between subsidiaries held for more than five years and those which are held for a shorter time period. If held longer than five years, the parent and subsidiary can begin to file consolidated returns and the parent can begin to avail itself of the subsidiary's tax attributes. Instead, if the parent liquidates the subsidiary, it can do so without recognizing recapture income. Additionally, section 334(b)(1) would give the parent a carryover basis in the assets received, just as would be the case under present law.

The proposed rules are quite different for target subsidiaries held for less than five years. Once the subsidiaries are "purchased," the parent has only 150 days to elect the benefits of section 334(b)(2). If election is made, the target must be liquidated within twelve months. At liquidation, the assets which the parent acquired receive a step-up in basis and the target must pay the recapture costs. Consolidated returns would not be available to defer or avoid the recognition of this recapture income.

If section 334(b)(2) is not elected, recapture income would still be recognized if the parent later decides to liquidate the target and the five-year period has not expired. Upon later liquidation, the carryover basis of the received assets would be increased by the amount of recognized recapture income attributable to each asset. Again, even if section 334(b)(2) were not elected, consolidated returns would not be available until five years have elapsed from the date on which the election period has expired.

These proposals do not require consistent treatment of (1) bona fide target affiliates which a corporation acquires or (2) target assets used in distinct businesses of the target. As long as the acquired assets are truly from separate and distinct businesses of the target, there is no sound policy reason for requiring consistency, whether assets are held by the target directly or in different subsidiaries.

These proposals are conceptually simpler and they provide much more certainty than present section 338, with its grants of broad regulatory authority to the Internal Revenue Service.